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IN THE

Supreme Court of the United States

OCTOBER TERM, 1961

No. 575

AMERICAN SURETY COMPANY OF NEW YORK, a corporation, *Petitioner,*

v.

SUNDBERG & SONS, a partnership, et al., and the UNITED STATES OF AMERICA

REPLY AND SUPPLEMENTAL BRIEF ON BEHALF OF PETITIONER

ARGUMENT

I

The question is whether enforcement of Section 6323(a), Internal Revenue Code, 1954, requires an application of the choateness rule to conventional mortgages

Respondent would have the Court treat this case as simply another statutory lien case to be controlled by the choateness rule enunciated in *United States* v. *New Britain*, 347 U.S. 80, and subsequent decisions following that rule, including *United States* v. *Ball Construction Co.*, 355 U.S. 587. This approach is reflected in the sole question presented in respondent's

brief, which is pitched entirely on Section 6321, Internal Revenue Code, 1954, the Section that gave rise to the choateness rule.

Petitioner submits that more than the choateness rule is involved here because this case presents a conventional mortgage within the meaning of Section 6323, a different section of the statute. The question here is whether a conventional mortgage, such as this, is subject to the choateness rule, in the light of the provisions of Section 6323 of the statute.

The decision in *New Britain* does not answer this question because involved in that case was the relative priorities of statutory liens, not the priority of a mortgage. Indeed the *New Britain* decision itself shows the Court was considering only Sec. 6321, and not Sec. 6323, when it said (Pg. 88), "There is nothing in the language of Section 3672 [now 6323] to show that Congress intended antecedent federal tax liens to rank behind any but the specific categories of interest set out therein, and the legislative history lends support to this impression." What this statement clearly means is that the Court was confining its attention to statutory liens comprehended by Section 6321, and was not considering the categories (such as mortgages) enumerated in Section 6323. It also seems to mean that if a conventional mortgage had been under consideration, the choateness rule would have no application.

Nor does the decision in *United States* v. *Ball Construction Co., supra,* furnish the answer, because in that decision there is no indication the Court felt it was dealing with a mortgage within the meaning of Section 6323. The decision merely states that,

> "The *instrument* involved being inchoate and unperfected, the provisions of Sec. 3672 (a), Revenue Act of 1939, 53 Stat. 449, as amended, 53 Stat. 882, 56 Stat. 957, do not apply." (Emphasis supplied)

Moreover, there are factual differences between this case and the *Ball* case. The lower Court found that presented here is a conventional mortgage according to the laws of the State of Washington. Previous decisions of this Court establish that the word mortgage as used in Section 6323 is to be construed in its usual and conventional sense. *United States* v. *Gilbert Associates, Inc.,* 345 U.S. 361, 364. Applying this rule, and citing Washington State authority, the Court below has held (Pet. 9a),

> "There can be no question but that under Washington law, if the mortgages were made to secure future advances, the trial Court was eminently justified in its determination that all advances under the mortgages related back, so far as the lien was concerned, to the date of the mortgage." [Citing 4 Pomeroy's Equity Jurisprudence (5th ed.) Sec. 1199, p. 596]

Likewise, Mr. Justice Story said in *Conard* v. *Atlantic Insurance Co.*, 26 U.S. (1 Pet.) 386, 448,

> "Mortgages may as well be given to secure future advances and contingent debts, as those which already exist, and are certain and due. The only question that properly arises is, the bona fides of the transaction."

No such established form of mortgage was present in *United States* v. *Ball Construction Co., supra.* On the contrary, involved there was an instrument (not further classified by this Court) not conventional in

character, which purported to assign to a surety the money yet to be earned by the contractor under a bonded contract, not only as security to the surety against any loss under the bonded contract, but also as security against loss by the surety resulting from any other contract between the parties. As it so happened, the loss involved in that case occurred under a contract other than the bonded contract mentioned. And so the *instrument* mentioned in *Ball* can hardly be regarded as a usual and conventional mortgage, as that term is used in Section 6323.

Respondent likewise relies on the decision in *United States* v. *Christensen,* 269 F. (2) 624 (Cir. 9); and *United States* v. *Bond,* 279 F. (2) 837 (Cir. 4), both of which involved the payment of some statutory state taxes by the mortgagee, after the filing of the federal tax lien, in order to protect the property against a forced tax sale; and the case of *United States* v. *Ringler,* D.C.N.D., Ohio, 166 F. Supp. 544. In the *Christensen* case there is some strong implication, not expressly mentioned, about the bona fides of the transaction, which, according to the decision, stemmed from a mortgage of $4,300, on some gambling property, to cover a note of $1,607. The Court held that the payment of taxes in the amount of $536.72 to protect the equity granted by this mortgage did not create a priority over an antecedent tax lien. In the *Bond* case the same sort of transaction was involved, although there seems no question about the *bona fides.* The *Bond* case involved payment of state taxes to protect the real estate, and also attorney's fees incurred in the litigation there present. The Court held that the federal tax lien antedated these payments and thus took priority, on the theory of first in time is

first in right. In the *Ringler* case, an attorney had taken an assignment to secure his fees for service thereafter to be rendered to a client in tax difficulties with the United States Government.

These are the cases chiefly relied upon by respondent. It is earnestly suggested that none of them arose from the kind of usual, conventional, established form of mortgage presented here. They all presented instruments or parts of instruments, of uncertain character, and outside the accepted type of mortgage document enumerated in Section 6323.

If the foregoing cases upon which respondent relies are to be accorded any weight, then they should be read along with decisions to the contrary, and of similar dignity, particularly the decision in *Gauvey* v. *United States,* 291 F. (2) 42, Cir. 8 (1961). This is a case in which a piece of equipment was sold under a conditional sales agreement, and also, the purchase price was secured by a chattel mortgage covering other equipment owned by the purchaser. The Court had no difficulty in holding that any of the categories enumerated in Section 6323 took priority over a subsequent tax lien, without regard to any choateness test. It quickly found that the chattel mortgage was one of the enumerated categories, and after some analysis it found that the conditional sales agreement, under the facts there presented, was likewise within one of the classes enumerated in Section 6323 (mortgage) and thus should not be subjected to any choateness test. Similar cases are *National Refining Co.* v. *United States,* 8 Cir., 160 F. (2) 951 (assignee of commissions to be earned held to be "purchaser"); *United States* v. *Boston & Berlin Transportation Co.,*

D.C.N.H., 188 F. Supp. 304 (buyer of trucking equipment held to be "purchaser", even though title was not to pass until after approval of sale by Interstate Commerce Commission); *Elliott* v. *Sioux Oil Co.*, D. C. Wyom., 191 F. Supp. 847 (assignment of income from oil leases to secure payment of debt held to be mortgage); and *Marteney* v. *United States*, 10 Cir., 245 F. (2) 135 (assignment of judgment while suit was still pending preferred over federal tax lien).

There are additional cases, some decided by the United States Court of Appeals for the Ninth Circuit, in all of which a mortgagee was preferred with respect to attorney's fees and similar expenses incurred after the tax lien was recorded, or with respect to state real estate taxes paid by the mortgagee after the recording of the federal tax lien: *United States* v. *Halton Tractor Co.*, 9 Cir., 258 F. (2) 612; *United States* v. *Sampsell*, 9 Cir., 153 F. (2) 731; and *Ormsbee* v. *United States*, S. D. Fla., 23 F. (2) 926.

If these numerous decisions serve no other purpose, they reflect a high degree of uncertainty on the part of lower courts concerning the rule to be followed in applying the terms of the pertinent sections of the Internal Revenue Code, 1954, to a mortgage, an uncertainty that would seem to dictate the grant of a writ of certiorari in this proceeding, so that a workable rule can be enunciated by this Court.

There is one additional point of importance which distinguishes this case from all cases cited in respondent's brief. In none of them does it appear that the advancement of the funds, when made, was a legal obligation, rather than the mere exercise of an option. In this proceeding the duty to make the

advances was obligatory, and was found to be under Washington law by the lower Court (Pet., 8a-9a).

> "The trial court concluded that they were mortgages to secure future advances and, relying on *Home Savings & Loan Ass'n* v. *Burton*, 1899, 20 Wash. 688, 56 P. 940; *Eltopia Finance Co.* v. *Colley*, 1923, 126 Wash. 554, 219 P. 24, and *Carey* v. *Herrick*, 1928, 146 Wash. 283, 263 P. 190, held that the priority related back to the date of the mortgage since the payments made were obligatory rather than optional. *Elmendorf-Anthony Co.* v. *Dunn*, 1941, 10 Wash. 2d 29, 116 P. 2d 253, 138 A.L.R. 558."

The mortgage presented here even meets the test laid down by the Internal Revenue Service itself in Unpublished Ruling A-619373, issued August 24, 1956, in that the advances made subsequent to recording of the federal tax lien were obligatory rather than optional.

It is well to bear in mind, in the light of the express provision in the mortgage, that the surety would be open to serious legal consequences if it had refused to consummate the advances it had promised to make; it would have not only been liable in damages to Sundberg, for breach of its mortgage agreement, but it would also have been liable to Boeing for failure to fulfill the condition of the performance bond, namely, to see the Sundberg contract completed according to its terms. In other words, the surety had no escape from the obligation to furnish the funds with which to complete the contract work, either by putting Sundberg in funds with which to do so, in accordance with the mortgage agreement, or by incurring the direct cost of performing the completion work itself, or through an entirely new contractor. Either way, the contractual obligation, when incurred,

was complete and valid between the parties immediately concerned, and since it antedated the filing of the federal tax liens, it was superior to those liens under the express wording of Section 6323, Internal Revenue Code, 1954. In this respect the document presented here differs from the instruments considered in the cases cited by respondent.

II

Money received by the surety (petitioner) from a separate source was not available for allocation by the Court to discharge Sundberg's earliest debts, and thus advance the position of the federal tax lien to first in point of time

Petitioner has made the argument, that the lower Court was in error when it sought to advance the priority position of the federal tax lien, by allocating certain monies received by the surety from Boeing, in such a way as to dissolve the initial advances made by the surety under the mortgage. With all due respect to respondent, petitioner has been unable to understand respondent's purported answer to this proposition (Reply, 8),

> "* * * it was manifestly necessary to apply those receipts against the surety's expenditures to determine the amount that the surety was out-of-pocket on the contract, i.e., the amount for which the Sundbergs are liable (and for which their properties stand as security)."

While the foregoing may be true, it is submitted it constitutes no answer to Point IV of the petition. (Pet. 9) Petitioner makes the point, and respondent admits (Reply, 8), that both as an express assignee, and by operation of law (*Henningsen* v. *United States F. & G. Co.*, 208 U.S. 404; *Prairie State Bank* v. *United States*, 164 U.S. 227), the surety was entitled to all sums that accrued under the Boeing contract.

This was money that it owned, money that neither Sundberg as principal on the bond, nor the United States as either an antecedent or subsequent tax lienor, could successfully claim according to an overwhelming preponderance of authority. This was not Sundberg money available for allocation to Sundberg's total indebtedness to the surety.

As of October 26, 1955, the filing date of the first federal tax lien, the surety had advanced to Sundberg an admitted total of $35,721.33. (Pl. Ex. No. 11—Rec. Pg. 76). This was all prior to the first recording of the tax lien. The lower Court, and respondent here, assert that in judging the relative priorities of the mortgage versus the tax lien, all of these initial advances must be disregarded, because during the same period that these initial advances were made the surety received from Boeing a total sum of $26,217.73 (Pl. Ex. No. 11—Rec. Pg. 76), and during the period following the first recording of the tax lien the surety received additional sums, more than enough to equal the figure of $35,721.33 mentioned above. (It will be noted that the receipts prior to the first filing of the tax lien, October 26, 1955, fell short of the total advances by $9,503.60.)

By reason of the foregoing receipts from Boeing, and in order to set up the tax lien of October 26, 1955, as first in time, the lower Court would allocate all of the receipts by the surety from Boeing as if they were Sundberg money, instead of surety money, and as authority for doing so, the lower Court cites in a footnote (Pet. 3a) certain Washington cases. The cases cited are undoubtedly the law of the State of Washington, as well as most other states, and they stand for the maxim—"First in, first out." This

maxim means that where a debtor makes a lump sum payment to a creditor, without specific allocation to any of numerous outstanding debts (advances), the Court will apply the payment beginning with the advance or debt that was "first in", meaning first incurred. But this maxim applies only where the court is dealing with a debtor-creditor relationship, and where payments by the debtor with the debtor's own funds are involved. It is never applied where the creditor has received money from a separate source, to which it already had legal and equitable title.

The lower Court erred, and respondent is in error, when it admits that the Boeing money was the property of the surety, not Sundberg, and at the same time attempts to apply the "first in, first out" theory in such a way as to dissolve the initial surety advances to Sundberg, and thus set up the initial recording date of the tax lien as first in point of time. Without this erroneous allocation, the tax lien was not first in time, and thus there is no basis for application of the choateness rule.

III

Uniform application of the revenue laws of the United States requires a direction from this Court concerning the filing of federal tax liens against partners and partnerships

Petitioner has made the point that the tax liens involved here named only the partnership whereas the property involved was held by the partners as individuals, and the petition cites *F. B. Baugh, Inc.* v. *Little Lake Lumber Co.* (Cir. 9), as holding that this filing does not conform to the requirements of Sections 6303 and 6321 of the Internal Revenue Code, 1954. The lower Court has held to the contrary.

Thus there is a conflict between the United States Court of Appeals for the Ninth Circuit, and the Supreme Court of the State of Washington. There has been no previous ruling by this Court on this subject. A uniform application of the revenue laws of the United States would seem to dictate a granting of the writ of certiorari so that the point can be finally settled. *United States* v. *Gilbert Associates, Inc.*, 345 U.S. 361, 364.

IV

An application of the choateness rule to mortgages to secure future advances would have a destructive effect on existing business practices

The legislative history of Section 6323 (a), taken together with the decision of this Court in *Brosnan* v. *United States*, 363 U.S. 237, 241, clearly establishes that in considering the relative position of federal tax liens in the business fabric of the country something more than first in time is first in right needs to be considered. In *House Report No. 1018, 62d Cong., 2d Sess. (1912)*, relating to a proposed amendment of Section 6323 (a), it was said,

> "The recent act relating to excise tax by corporations makes it imperative that some legislation of this kind be enacted in order to protect the transfer of property, and to facilitate business transactions. There is no reason why the Government should not occupy the same position with reference to liens on property as does the individual."

In *Brosnan* v. *United States, supra*, this Court was considering a sale of property under a *fieri facias* which had the effect of extinguishing a junior federal tax lien, and said,

> "* * * We think it more harmonious with the tenets of our federal system and more consistent with what Congress has already done in this area not to inject ourselves into the network of competing private property interests, by displacing well-established state procedures governing their enforcement or superimposing on them a new federal rule. Cf. *Board of Comm'rs* v. *United States,* 308 U.S. 343."

To apply the rule of choateness to the facts of this case would unquestionably disrupt, if not destroy, many conventional practices, established for a long period of time in the financial, and particularly the construction industry. It would inject a new rule of taxation into an existing network of competing private property interests. On construction projects, particularly those related to housing, mortgages to secure future advances to be made as the work progresses, have become a fixture. The same is true to a lesser extent in the heavy construction industry. Another important application of the technique finds its place in agriculture, where mortgages are frequently used to secure future advances to be made as crops develop. There are other applications too numerous to mention.

If the choateness rule is to be uniformly applied to this type of mortgage, on the strength of previously decided cases, then a writ of certiorari is here required so that such a rule can be unequivocally announced by this Court for the benefit of all concerned. As was said in *United States* v. *Gilbert Associates, Inc.,* 345 U.S. 361, 364: "A cardinal principle of Congress in its tax scheme is uniformity, as far as may be. Therefore, a 'judgment creditor' [as used in 26 U.S.C. (1946 ed.), Sec. 3672] should have the same application in all the states."

Under the present condition of the law, as it exists since the *per curiam* decision in *United States* v. *Ball Construction Co., supra,* great confusion prevails in the lower courts, and in the legal profession, regarding the relationship between the choateness rule and the provision of Section 6323 (a), Internal Revenue Code, 1954. This fog can be dispersed by a consideration by this Court of this case at this time.

Respectfully submitted,

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February 9, 1962